

Pre-Trade Transparency in Corporate Bond Markets: A Survey of Regulatory Alternatives



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1

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SECTION TITLE | 2

Agenda



Discuss types of pre-trade transparency that we may consider:

1. Pre-trade disclosure of markups for riskless principle trades (“RPTs”)
2. Pre-trade dissemination of quoted and indicated prices
3. Broad representation of customer limit orders

Markups and Commissions



Pre-Trade Markup Disclosure



- Riskless principal trades are essentially brokered trades for which the markup is the commission.
- Pre-trade transparency would allow customers to shop on price.
- Most small RPTs are arranged electronically so that search costs are minimal.

Recent Regulation



- RPT markups will soon be post-trade transparent.
- But to shop on price, you must trade with multiple brokers.

Arguments for/against Regulation

- For: Publication of RPT markup schedules would promote competition among brokers.
- Con: Post-trade markup transparency increases incentives for some brokers to disclose their markup policies.
 - Displaying brokers can more easily attract orders now that clients can know the markups they pay.



Pre-Trade Price Transparency

Quoted and Indicated Prices



- Most corporate bond volume trades in markets with two-sided quotes or indications.
 - But many bonds trade by appointment only.
- Quoted size generally is small, but dealers often replenish size automatically.

Indications



- Indications are not strictly firm but dealers usually stand behind them.
- They fade when information is present or they suspect a large order.

Potential Transparency Benefits



Greater pre-trade price transparency would

- Improve the competition for best price because traders can more easily shop for best price.
- Increase dealer incentives to compete on price.
- Reduce the costs to clients of monitoring best execution.
- Improve pricing of bond funds.

Market-Based Innovations



- Many vendors are now assemble pre-trade price information.
- The information largely benefits broker-dealers, proprietary traders and large buy-side institutions.

Retail Traders



- Retail traders do not generally see pre-trade price information as they do in equities.
- They benefit indirectly when brokers using this information obtain better prices for them.

Best Execution



- Best execution is a broker-dealer responsibility.
- History in all markets regrettably shows that some B-Ds do not take this responsibility seriously, especially when dealing to their clients.

The Best Execution Problem



- Slippage in best execution is greatest when customers cannot measure the quality of their executions.
 - Measurement requires pre-trade information and some analytic sophistication.
 - The problem affects retail traders most, but also many institutional traders.

Regulatory Issues



- Pre-trade price transparency facilitates the regulation of best execution and cheapens surveillance and enforcement costs.
 - The threat of enforcement deters bad behavior.

Fair Enforcement



- Fair and uniform enforcement requires a standard national best bid or offer of accessible prices.
- Delegating the production of a standard NBBO to multiple private entities would be problematic.

Policy Alternatives (1)



1. Do nothing.
2. Require B-Ds to present pre-trade prices from some reputable source to their clients.

More Policy Alternatives



3. Have some entity—probably FINRA or perhaps a consortium of exchanges—to produce and disseminate an NBBO.
 - The existence of an NBBO probably would cause dealers to convert most indications to firm quotes.
4. Prohibit trade-throughs for electronically accessible quotes.

Representation of Limit Orders



Current Practice



- Most brokers will not represent client bond limit orders in electronic trading systems.
 - Those brokers that will display a client order usually restrict display to a short period or require all-or-nothing executions.
- Interactive Brokers is the major exception.

Implications



- These policies help ensure that clients trade with their broker-dealers.
- They also prevent clients from competing with broker-dealers and proprietary traders.
- Some industry participants argue that these policies protect clients from poor executions.

Implications for Liquidity



- Transaction costs are lowest when the buy-side can meet the buy-side directly.
- Dealers widen spreads when they fear trading with informed traders.
- In contrast, buy-side traders price more aggressively when they fear not trading if informed traders are present.

The Chicken and Egg Problem



- The industry reports that most clients do not want to trade limit orders.
- Do clients have little intrinsic interest? Or do they do not express interest because facilities are not available to them?
- A trade-through rule would make exposure more attractive to clients.

Regulatory Alternatives



1. Do nothing: Clients who want to expose bond limit orders will migrate to brokers like IB that support these services.
2. Require brokers to route standing client limit orders to an existing or purpose-created bond order display facility.
3. Add a trade-through rule to protect standing limit orders.

Alternative Regulatory Approaches



The Current Regulatory Path



- Our current path—like the NASDAQ path of the 1970s-1990s—has been incremental imposition of order handling rules.
 - TRACE Post-trade price transparency (2002-5)
 - Post-trade markup transparency (2018)
 - Possible pre-trade markup transparency (20??), NBBO (20??), trade through regulation (20??).

An Alternative Regulatory Path



- Do a pilot study in which the most actively traded bonds trade under a full set of order handling rules.
- Easy to implement as the software systems that trade equities already have all the required functionality.